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IN THE

Supreme Court of the United States

HCA INC. & SUBSIDIARIES, SUCCESSOR TO
HOSPITAL CORPORATION OF AMERICA & SUBSIDIARIES,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

BRIEF OF THE FEDERATION OF AMERICAN HOSPITALS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

The Secretary of the Treasury is explicitly prohibited by 28 U.S.C. § 448(d)(5) from adopting any Treasury regulation that requires certain taxpayers, including petitioner and the private hospitals represented by amicus curiae Federation of American Hospitals ("FAH"), to include as taxable income "any portion" of accounts receivable "which (on the basis of experience) will not be collected." It is not contested that the exclusion method required by Treas. Reg. § 1.448-2T(e)(2) (1988) did *not* reflect the "experience" of private hospitals in collecting their accounts receivable – the undisputed record establishes that the Treasury regulation required private hospitals to include in taxable income as much as 80% of accounts receivable that they would not, in fact, collect at any time.

Amicus curiae FAH will address the following question encompassed by the petition for a writ of certiorari:

Whether 28 U.S.C. § 448(d)(5) bars the Treasury Department from enforcing a regulation, such as Treas. Reg. § 1.448-2T(e)(2) (1988), that requires a taxpayer to include as taxable income receivables that its experience shows will not be collected.

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BRIEF OF THE FEDERATION OF AMERICAN HOSPITALS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

This brief is filed on behalf of the Federation of American Hospitals, as amicus curiae in support of petitioners, with the written consent of the parties.[1]

INTEREST OF AMICUS CURIAE

The Federation of American Hospitals ("FAH") is the national representative of privately owned or managed community hospitals and health systems throughout the United

[1] Letters of consent have been filed with the Clerk. This brief has not been authored in whole or in part by counsel for a party, and no person or entity other than amicus curiae, its members or counsel have made a monetary contribution to the preparation and submission of this brief.

States. Its members, which range from small rural to large urban hospitals, offer a variety of services including acute hospital care, outpatient services, skilled nursing care, rehabilitation, and psychiatric care.

This case is critically important to FAH's members because of continuing and increasing difficulties the nation's hospitals are experiencing in collecting on unpaid hospital bills. In this case, petitioner – a large private hospital corporation – was required to pay taxes on a large portion of its receivable income that petitioner knew it would never actually collect. Petitioner's situation is not unique: the problem of uncollectible debt is endemic in the private hospital industry, and private hospitals have long been forced by an arbitrary regulation to pay taxes on income they know from experience they will not receive. FAH and its members strongly believe the Court should grant review and require Treasury to adhere to the rational and sound system mandated by Congress for calculating the amount of not-yet-collected income a hospital must include as taxable income.

INTRODUCTION AND SUMMARY

This case presents a question with enormous consequences for the Nation's private hospitals. Hospitals typically do not require cash payment in full from patients immediately upon the rendering of services. Instead patients, or their insurers, are billed for services provided. Amounts due with respect to outstanding invoices are referred to as "accounts receivable." Hospitals often do not collect payment on their accounts receivable for many months after they bill – and they do not collect a substantial percentage of their accounts receivable at all. Indeed, as we elaborate in this brief, the problem of uncollectible receivables – often referred to as "bad debt" – is a serious and growing one for hospitals nationwide.

As a practical matter, the question in this case is how much tax private hospitals should be required to pay on in-

come they know they will never receive. As a technical matter, the question is what percentage of the accounts receivable private hospitals (and other qualifying service providers) have at the end of a year should be included as "income" for that year. In theory, of course, the answer could be zero percent, since the hospital has not *actually* received payment. Under what is known as the "cash" method of accounting, that is exactly the result: the cash method includes as income only the cash actually or constructively received in a given year, so accounts receivable are ignored.

Conversely, the answer could be that a hospital should include as income 100% of its year-end accounts receivable, even though the hospital has not yet actually received any of the income. This is one possible result of an "accrual" method of accounting, under which a taxpayer counts as taxable income all income that is *earned* (i.e., to which it has obtained a fixed right) in a given year, even if the income has not yet been collected. Many service providers are required to use an accrual method for calculating income.[2]

An accrual method, however, creates an obvious problem – the problem at the heart of this case: if a taxpayer includes as taxable income all of its year-end accounts receivable, but is then unable to collect some portion of those receivables, the taxpayer pays taxes on income that it never receives. Accordingly, the Code and its accompanying regulations have over the years articulated different formulas that taxpayers using an accrual method can employ to calculate the portion of year-end receivables that should not be subject to taxation because they are not likely ever to be collected.

The formula used for calculating the amount of receivables a taxpayer such as a hospital can reasonably expect to

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[2] An accrual method accelerates tax revenues because it allows the Government to collect taxes on earned income sooner than the cash method, under which the Government must wait until the provider actually collects cash before taxes may be imposed.

collect is, of course, critical to the determination of a given year's taxable income and, therefore, to the amount of tax to be paid. If the calculation method underestimates the amount that will be uncollectible, then it includes too much income for that year, effectively forcing a taxpayer to pay an artificially high amount of taxes. Conversely, if the method overestimates the amount of receivables that ultimately will be written off, then a taxpayer's income will be understated, rendering its tax bill artificially low.

While no method will be perfect – inasmuch as the entire enterprise is about *estimating* the portion of receivables the taxpayer is likely to collect ultimately – all should agree that the correct approach should be one that reflects, to the greatest degree possible, an *accurate* estimate of what receivables will be recovered, and thus what income the taxpayer truly will receive. What is astounding about this case is that Treasury *does not dispute* that the calculation method prescribed by Treas. Reg. § 1.448-2T(e)(2) (1988) *did not even come close* to accurately identifying the actual income private hospitals would receive from their year-end receivables in a given year. Nor does Treasury deny that there are numerous other methods that *would* have predicted actual income for private hospitals much more accurately.

This arbitrary regime would be bad enough if the Tax Code were merely silent about the proper method for calculating the portion of receivables to include as income. But in fact, the Code expressly requires Treasury to allow private hospitals and other qualifying service providers to calculate their taxable year-end accounts receivable on the basis of a formula that reflects the *actual experience* of the taxpayer in recovering receivables. Nobody disputes that the method petitioner used in preparing its tax returns accurately reflected its actual experience, and that Treas. Reg. § 1.448-2T(e)(2) (1988) did not. That regulation flatly contradicted the letter of the Code and the expressed will of Congress. And in so doing, it imposed an extraordinary, wholly unjusti-

fied tax burden – one based on income that would never be collected – on the many taxpayers who, like petitioner, provide services and receive payments over long billing cycles.

This Court should grant certiorari and reverse the judgment below upholding the regulation.

REASONS FOR GRANTING THE WRIT

Petitioner has already ably marshaled the basic reasons review should be granted. In this brief FAH demonstrates the extraordinary importance of this issue to the nation's private hospitals, especially given the growing problem of uncompensated care – that is, care that hospitals provide but for which they are never paid. The tax regime at issue in this case forces private hospitals to pay taxes on more of their accounts receivable than they will actually collect. And the more that private hospitals are unable to collect on their accounts receivable, the more they are adversely affected by this tax regime.

We first briefly summarize the background to this problem, explaining in particular the way that the various accrual-accounting tax rules have affected private hospitals. We then show why the rule involved here has such exponentially adverse effects on private hospitals, and why recent rule changes do not adequately address the problem and thus do not undermine the case for certiorari.

A. Background: From *Black Motor* To Stark Fiction

1. Prior to 1986, taxpayers generally could choose whether to employ cash or accrual accounting in calculating their annual tax bills. Accounts receivable were treated differently under the two methods. Under the cash method, a taxpayer would count only income actually or constructively received during the year as taxable income; accounts receivable were meaningless and ignored. Under an accrual method, by contrast, taxpayers would count any amount due still outstanding at the end of the year as earned income for that year, but they were allowed to deduct from that year's

income a "reasonable" amount placed in reserve for bad debts. A "reasonable" reserve amount was understood to be an amount "that can be expected to cover losses properly anticipated on debts outstanding at the end of the tax year." *Thor Power Tool Co. v. CIR*, 439 U.S. 522, 546 (1979). Thus, if a taxpayer had a right to $100,000 at the end of the year, and could properly anticipate that it would never recover $20,000 of that amount, the taxpayer could include $20,000 in a reserve and deduct that amount from that year's income.

The question, of course, was how accrual-basis taxpayers were supposed to calculate a "reasonable" amount of expected losses to reserve as bad debt. The formula applied by Treasury was derived from *Black Motor Co. v. CIR*, 41 B.T.A. 300 (1940), *aff'd*, 125 F.2d 977 (6th Cir. 1942). In general, the "*Black Motor* formula" sought to establish the "reasonableness" of the taxpayer's bad-debt reserve by reference to "the taxpayer's [bad debt] charge-off history." *Thor Power*, 439 U.S. at 547. To establish the taxpayer's bad debt charge-off history, the formula looked to the current and most recent five years, and compared the taxpayer's average year-end receivables for that period to the average amount of debt written off (i.e., declared uncollectible) each year during the same period, adjusting write-offs for "recoveries" (i.e., debt that was written off as uncollectible but later actually collected). Thus, if a taxpayer had an average of $100,000 in receivables at each year's end, and wrote off an adjusted average of $20,000 during each year, the *Black Motor* formula essentially calculated that the taxpayer had been failing to recover 20% of its receivables in its experience. The taxpayer would then apply that percentage to its current year-end receivables – on the assumption that this experience would reflect the likelihood of actually collecting on those outstanding accounts – and could deduct that amount from its income as part of its "bad debt reserve." Recognizing the primacy of actual experience, however, Treasury would al-

low a taxpayer to add *more* to its bad debt reserve than the *Black Motor* formula would allow (or would require a taxpayer to reduce its bad debt reserve from that which the *Black Motor* formula would allow), when the formula, as applied in a given instance, generated "an arbitrary result" because "a taxpayer's most recent bad-debt experience [wa]s unrepresentative for some reason." *Thor Power*, 439 U.S. at 549; *see* Rev. Rul. 76-362, 1976-2 C.B. 45.

2. In 1986, Congress mandated accrual-based accounting for most service providers (including private hospitals) but eliminated the bad-debt reserve method. Congress determined that, rather than placing estimated bad receivables into a reserve account and taking a deduction, these service providers should simply exclude from taxable income the amount of year-end receivables they could expect never to collect. And to determine what amount the taxpayer could reasonably expect would be uncollectible, Congress explicitly required Treasury to rely on a taxpayer's actual collection experience:

> SPECIAL RULE FOR SERVICES. – In the case of any person using an accrual method of accounting with respect to amounts to be received for the performance of services by such person, such person shall not be required to accrue any portion of such amounts which (on the basis of experience) will not be collected.

28 U.S.C. § 448(d)(5). Because the amount of uncollectible debt was to be calculated based on experience and was to be excluded from accrued income, this provision established what is called a "nonaccrual-experience method" for establishing the amount of year-end receivables that service providers were required to exclude from accrued income. The provision was unusual in that it was directed at Treasury rather than taxpayers; whereas most tax laws require taxpayers to account for income in a particular way, the new

§ 448(d)(5) directed Treasury to allow these taxpayers to exclude from accrued income receivables that their experience showed they were not likely to collect.

3. Treasury's response to the new § 448(d)(5) was to promulgate a regulation requiring all qualifying taxpayers subject to the provision to employ the old *Black Motor* bad-debt reserve formula – what petitioner calls the "Original Formula" – as the method for calculating the amount of year-end receivables to be excluded from accrued income. Temp. Treas. Reg. § 1.448-2T (1987). But instead of allowing adjustments to the exclusions for taxpayers for whom the *Black Motor* formula did not "work" (i.e., for whom the formula resulted in an arbitrary, inaccurate estimate of future bad debt) – as was the practice under *Black Motor* itself – the initial Treasury regulation simply mandated *Black Motor* in all cases.

A problem arose almost immediately. Although the Original Formula reflects with reasonable accuracy the actual bad debt experience of taxpayers with long billing cycles, such as private hospitals, Treasury soon became aware that the Original Formula did *not* "work" for taxpayers with especially short billing cycles and quick write-off periods – most notably, utilities. Utilities represented a unique situation because they typically are able to compel payment for their services in a very short time period compared to other service providers – basically because when a utility bill is not paid, the utility can cut off and deprive the customer of an essential service. Other providers lack such "self-help" means of compelling payments; they must instead rely on slower-moving means of legal compulsion. In consequence, utilities are able to resolve most debt issues quickly and identify particular debts as uncollectible much earlier than other providers can. This means that, in the course of a given year, utilities will write-off a high percentage of their debt in the same year the debt is incurred, compared to other providers (such as hospitals). And for reasons explained in

the margin, Treasury quickly realized that the Original Formula would overestimate the bad debt of a utility (or any other similarly situated taxpayer) that writes off debt in the same year it is incurred, thereby understating actual income.[3] *See Accountants and Treasury Debate Nonaccrual Experience Method*, Tax Notes Today, Dec. 2, 1988 (describing Treasury official observation that "[u]se of the *Black Motor* formula could cause severe distortions in the amount of bad debt reserves accrued, particularly with respect to receivables having short lives"); *Sutherland, Asbill & Brennan Proposes Alternative Formula for Computing Required Exclusion Under Non-Accrual Experience Accounting*, 88 Tax Notes Today, Sept. 1, 1988 ("Under the original formula, the taxpayer might have been allowed too great an exclusion if its write-off policy provided for write-offs of current charges in the current year.").

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[3] The problem is essentially one of "double counting" a utility's bad debt. Recall that the *Black Motor* formula relies on a comparison between each year's year-end receivables and the total (adjusted) write-offs for that year. If a taxpayer consistently writes-off debt in the same year it arises, then the taxpayer's year-end receivables are *already reduced* by the amount written off, but that same amount of written-off debt is then used *again* to predict what *additional* amount will not be collected. In other words, a utility's bad debt is "counted" once as a receivable that will not be collected (because it is written off and thus taken out of year-end receivable income) and again as *another* receivable that will not be collected (because it is used as a predictor of the year-end receivables that will not be collected). As one contemporaneous commentary explained, "whenever the taxpayer's write-off practices were such that it wrote off during the current year charges for credit transactions of the current year . . . the taxpayer would obtain a bad debt deduction for the amount of the write offs and would also obtain an additional exclusion based on these same amounts." *Sutherland, Asbill & Brennan Proposes Alternative Formula for Computing Required Exclusion Under Non-Accrual Experience Accounting*, 88 Tax Notes Today 180-37 (1988). This double-counting overestimated the amount of the year-end debt that would go bad and thus understated the amount of such debt that should be included as accrued income.

4. Treasury sought to correct the problem, but it blundered badly. Rather than simply exclude utilities from the mandatory formula set forth in the regulation, or adopt some means of adjusting the results for situations where same-year write-offs caused the formula to fail, Treasury rewrote the regulation as if utilities and other short-billing-cycle taxpayers were the only taxpayers affected by it. *See* Treas. Reg. § 1.448-2T (1988). Under the "Revised Formula," a taxpayer compares its write-offs for each year (of the current and most recent five) to its total annual *charges* for that year (not to its year-end receivables for that year, as under *Black Motor*). This produces the estimated percentage of overall annual revenues that will not be collected. That percentage is then applied to year-end receivables to produce an estimate of those receivables that will not be collected. In other words, the Revised Formula assumes that the percentage of total billings that will be uncollectible is roughly the same as the percentage of year-end receivables that will be uncollectible. This assumption works for utilities, because their year-end receivables have already been largely "cleansed" of specific uncollectible accounts from that year, meaning that year-end receivables are really little more than current outstanding invoices for credit charges, which will be collected in roughly the same proportion as total annual charges. For other, slower-collecting taxpayers, however, the percentage of total charges that will never be paid is *not* the same as the percentage of year-end receivables that will be never be collected: since comparatively little of the bad debt arising during the year has been written off by year end, the bad debt simply gathers on the books, so that whatever receivables still remain at year's end necessarily include a disproportionately high percentage of uncollectible charges. Accordingly, for these taxpayers – including the nation's private hospitals – estimating bad debt by comparing average annual write-offs to average annual charges, and then applying that ratio to current year-end receivables, has the effect of grossly un-

derestimating the percentage of those receivables that will never be collected, and thereby grossly overstating the percentage of receivables that is subject to taxation. *See Sutherland, supra* (revised formula "penalizes a taxpayer who does not write off current year charges during the current year"). Petitioner's situation is stark but, FAH can attest, not unusual: the Revised Formula requires petitioner to include as accrued income – and thus pay taxes on – 80% of receivables that, experience shows, petitioner will never actually receive. Pet. 9.

The Revised Formula, in short, has nothing whatsoever to do with the actual bad-debt "experience" of hospitals. It was explicitly designed to address the experience of one category of taxpayers, without regard for the experience of others. Indeed, it bears emphasis that, as petitioner points out, *nobody denies that the revised formula does not reflect hospitals' bad-debt "experience,"* contrary to the statute's utterly unambiguous mandate. That alone should warrant review and reversal of the decision below upholding Treasury's use of the formula. But as we show in the next section, the negative consequences of underestimating bad debt – and thereby overstating accrued income – are especially severe for the nation's private hospitals, for whom bad debt is already a serious and rapidly expanding problem.

B. Underestimating Bad Debt Is Especially Harmful To Private Hospitals, Which Are Already Suffering A Growing Problem With Actual Bad Debt

Properly calculating bad debt for tax purposes is profoundly important to the nation's private hospitals because bad debt is a severe and rapidly growing problem for those hospitals. If the tax laws underestimate bad debt, hospitals suffer twice: once because they never receive the income actually written off, and again because they initially paid taxes on nearly all that income as if they had actually received it. What is more, the growing bad debt crisis – the

word is no exaggeration – is part of a vicious cycle that imposes an upward pressure on healthcare costs that harms everyone. In these circumstances, allowing the Treasury to apply the nation's tax laws to exacerbate the costs of hospitals' bad debt by treating it (or any part of it) as actual, taxable income, is a senseless policy.

A series of recent reports in the nation's business press have detailed the "soaring" problem hospitals are experiencing in recovering payment for care they provide. Rhonda L. Rundle & Paul Davies, *Hospitals Start to Seek Payment Up Front*, Wall. St. J., June 2, 2004; *see* Rhonda L. Rundle & Paul Davies, *Hospitals Administer Antidote for Bad Debt*, Wall St. J., May 4, 2004; Dean Foust, *Weaker Vital Signs at Hospitals*, Bus. Week, May 3, 2004; *Bad Debt Afflicting Hospitals' Bottom Line*, April 30, 2004; Maggie Mahar, *Hospitals' Terminal Disease*, Fortune, May 31, 2004; Roger Yu, *Bad Debt Is Causing Pain for Hospital Firms*, Dallas Morning News, Nov. 16, 2003; Loren Steffy, *Numbers Tell the Health Care Story, and They're Ailing*, Houston Chronicle, June 2, 2004. The news is grim. In 2003, bad debts reached a total of $22.3 *billion* industry-wide, almost twice as much as in 1990. Rundle & Davies, *Bad Debt*, *supra*. Major hospital companies now report that uncollectible accounts equal or exceed 10% of their overall annual revenues. *Id.*; Houlihan, Lokay, Howard & Zukin, *Healthcare Quarterly Update: Q1 2004*, at 8. At the same time bad debt has increased dramatically, hospital margins have declined, dropping from 6.1% in 1996 to 3.4% in 2000. Medicare Payment Advisory Commission, *Report To The Congress, Medicare Payment Policy*, March 2003, at 39. According to one leading market analyst, rising bad debt is the "biggest risk to earnings in 2004 for the hospital industry." Bear, Stearns & Co., *Health Care Facilities*, April 2004, at 19; *see also* Rundle & Davies, *Bad Debt*, *supra* (reporting that another analyst recently "sounded an alarm about bad debt").

The bad-debt problem for private hospitals is even worse

than it appears. The increase in bad debt expenses is caused by two related factors. The first is the rising number of uninsured patients seeking care. *See, e.g.*, Foust, *Weaker Vital Signs*, *supra*; Rundle & Davies, *Payment Upfront*, *supra*. Hospitals have legal and ethical obligations to provide care in many situations regardless of a patient's ability to pay. Accordingly, even uninsured patients often can receive treatment – albeit often at emergency rooms, only after a medical need has become acute, at which point care is the most expensive to provide. "When the uninsured get sick, they go to emergency rooms, where hospitals are required by federal law to treat them regardless of their ability to pay. As a result, hospitals' charges for bad debts have soared." Steffy, *Numbers Tell the Health Care Story*, *supra*. The second, related factor is the increasing number of patients who do have insurance, but with deductibles and co-payments that they cannot afford to pay. "[C]ompanies that provide medical coverage increasingly are making employees pick up more of the costs. Roughly a third of employers now require workers to front annual deductibles ranging from $1,000 to $5,000 before payments kick in. As a result, hospitals say they're having a harder time getting the insured to cover their deductibles." Foust, *Weaker Signs*, supra; *see* Yu, *Bad Debt Is Causing Pain*, *supra* ("One reason for the growth in unpaid bills by insured patients, experts said, is that more employers are rolling out health plans that are designed to pass on more of the cost to employees."); *Indigent Care Spending Low*, Modern Healthcare, Feb. 23, 2004.

Bad debt is a bigger problem than it appears because hospitals have few effective means of improving their collection experience. In the first place, the main causes – increasing numbers of uninsureds and increasing deductibles and copayments – are beyond hospitals' control, and experts do not believe they are trends likely to reverse themselves. *See, e.g.*, Standard & Poor's, *Credit FAQ: Hospital Bad Debt Expenses and Charity Care*, June 2, 2004. Whereas in the

past, economic recoveries typically meant that "many of the unemployed found new jobs that provided medical insurance," Foust, *Weaker Signs*, *supra*, today fewer employers are providing coverage at all, and those that do provide coverage shift more costs onto employees, *id.* In particular, "the rise in unpaid bills from insured patients" may reflect "a sign that an economic rebound won't solve the problem, that too much of the burden has been shifted to employees who can't afford to pay." Steffy, *Numbers Tell the Health Care Story*, *supra*; *see* S&P, *Hospital Bad Debt Expenses*, *supra* ("Even if economic recovery mitigates the growth in the number of uninsured – which stands at 44 million – bad debts will reflect the fact fewer companies are providing insurance, and the relative value of benefits is decreasing."). Health care market analysts believe that these developments may reflect a "fundamental change" in the health care insurance market, which could make high bad debt levels a "permanent" feature of hospitals' balance sheets. Rundle & Davies, *Bad Debt*, *supra*; *see* S&P, *Hospital Bad Debt Expenses*, *supra* ("The problem of bad debt is not temporary.").

In addition to the systemic problem of uninsured and underinsured patients – which creates bad debt problems for hospitals unlike those faced by any other taxpayer – hospitals also face unique collection difficulties. Other taxpayers with outstanding accounts have various means of enforcing their rights as creditors, including liens, garnishments, and other legal measures. Hospitals, however, face intense social and political pressure not to employ such measures against former patients for unpaid bills. For example, Congress called hearings to focus on hospital collection efforts when word spread that hospitals were attempting to improve their collection rates, and Connecticut has enacted a law that restricts hospital collection efforts. Vince Galloro, *Bad News On Bad Debt*, Modern Healthcare, Oct. 27, 2003, at 8. Similar bills have been introduced in California to regulate hospital collection activities. Cinda Becker, *Balance Past Due*, Modern

Healthcare, Sept. 22, 2003.

Despite these obstacles, hospitals are doing their best to mitigate the growth of bad debt expenses through innovative billing and collection techniques, *see, e.g.*, Rundle & Davies, *Payment Upfront*, *supra*, but bad debt clearly is going to remain a problem so long as the number of uninsured and underinsured patients continues to rise. Unfortunately, there is a circular dimension to the problem: to cover the costs of providing uncompensated care, hospitals must shift costs to those more likely to pay (i.e., the insured), which increases insurance premiums, which decreases the coverage employers are willing to provide, which drives up the number of uninsured and underinsured patients, which in turn increases the costs of providing care to insureds, and so on. *See* Steffy, *Numbers Tell the Health Care Story*, *supra*. This cycle could be broken – or at least slowed – if bad debt expense could be brought under some measure of control.

By prohibiting Treasury from requiring taxpayers to include in income amounts that their experience shows would not be collected, the Tax Code at least attempts to ensure that tax policy does not exacerbate hospitals' bad debt problems. The Revised Formula imposed by Treasury, however, has had exactly the opposite effect, because it did exactly what that statute prohibited: it openly and grossly underestimated the amount of bad debt a hospital would incur, and thereby forced hospitals to include as income huge amounts of bad debt that would never actually be collected. This imposed a double penalty on private hospitals already straining under the weight of bad debt. Suppose, for example, that a hospital expected to incur $1,000,000 in bad debt in a given year, but the Revised Formula predicted only $200,000. The hospital would lose the full $1,000,000, but it would also pay taxes that year on $800,000 it would never actually receive. Such an outcome is not only arbitrary – and therefore indefensible on its own terms – it is affirmatively unsound, in view of the breadth and depth of the existing problem with bad debt, and

the effects of that problem on the efficient delivery of health care in this country. This case is, in short, about much more than the taxes to be paid by one taxpayer or even tax policy generally. It is a matter of urgent U.S. *health-care* policy that Treasury be required to follow the Code's mandate that hospitals be allowed to account for bad debt in accordance with their true experience.

C. Recent Rule Changes Do Not Fulfill Congress's Directive That Taxpayers Be Allowed To Exclude Receivable Debt From Accrued Income On The Basis Of Their Actual Experience

As petitioner notes, Congress was aware that the formula Treasury devised to address the experience of utilities and other taxpayers with short billing cycles did not address the experience of hospitals and other taxpayers with longer billing cycles. Pet. 7-8 & n.5. As one letter to Treasury from two high-ranking members of Congress observed:

> The current nonaccrual experience rules appear to overstate hospital income because they fail to consider the likelihood that the receivables a hospital holds at year end will not be collected. . . . Hospitals are increasing[ly] subject to financial pressures and the proper measurement of income for tax purposes is more critical than ever.

Sen. Thompson and Rep. Thomas Express Concern About Nonaccrual Experience Method of Accounting, Tax Notes Today, Feb. 3, 2000; *see also Senators Express Concern About Problems Facing Health Care Providers*, Tax Notes Today, March 2, 2000 (reprinting letter to Treasury from Sens. Daschle and Robb observing that the Revised Formula "as applied to health care providers may not accurately reflect their actual experience of uncollectible billings"). The House Ways & Means Committee identified the same problem:

> [T]he formula in Temp Reg. 1.448.2T may not clearly reflect the amount of income that, based on experience, will not be collected for many qualified service providers, especially for those where significant time elapses between the rendering of the service and a final determination that the account will not be collected.

H.R. Rep. No. 107-251 (2001), at 54, *reprinted in* 2002 U.C.C.A.N. 20, 58.

In 2002, Congress inscribed its concerns into the statute itself, sharply reiterating its 1986 directive to Treasury to allow taxpayers to exclude from accrued income the receivables they know from experience they will never collect. Congress did not revise the substantive terms of § 448(d)(5), but instead added a subparagraph that essentially ordered Treasury to comply with those terms:

> (C) The Secretary shall prescribe regulations to permit taxpayers to determine amounts referred to in subparagraph (A) using computations or formulas which, based on experience, accurately reflect the amount of income that will not be collected by such person. *A taxpayer may adopt, or request consent of the Secretary to change to, a computation or formula that clearly reflects the taxpayer's experience. A request under the preceding sentence shall be approved if such computation or formula clearly reflects the taxpayer's experience.*

28 U.S.C. § 448(d)(5)(C) (emphasis added).

In response, the Treasury issued a new Temporary Regulation in 2003. *See* 68 Fed. Reg. 52496 (Sept. 4, 2003); Temp. Treas. Reg. § 1-448-2T (2003). That regulation establishes four "safe harbor" methods a taxpayer may employ to calculate receivables to be excluded from accrued income. Two of those safe harbors are modified versions of the *Black Motor* formula, *see* 68 Fed. Reg. at 52497, and thus it may at

first appear as if the regulation has effectively mooted the issue in this case going forward. Not so. Even leaving aside the fact that the new regulation provides no relief for petitioner and other hospitals who have overpaid taxes for many years on the basis of the flawed formula imposed by the 1988 Regulation, the new regulation is not a true "fix" for the problem here because it fails to address the fundamental error at the heart of Treasury's approach to the nonaccrual-experience method established by § 448(d)(5).

Section 448(d)(5) as enacted in 1986 plainly shifted the traditional regulatory relationship between Treasury and the taxpayer. Most tax laws impose duties on the taxpayer, but § 448(d)(5) imposes a duty directly on Treasury – specifically, the duty to allow accrual-basis taxpayers to use their experience as the basis for calculating receivables to be excluded from income. But the new regulation, while concededly authorizing the use of certain methods that may reflect taxpayers' actual experience, nevertheless ignores the basic thrust of § 448(d)(5): Treasury may *not* confine taxpayers to any particular, fixed or predetermined method for calculating appropriate exclusions from accrued income. Rather, Treasury's role under the plain terms of § 448(d)(5) is simply to ensure that a taxpayer's method – *whatever it may be* – captures expected bad debts on the basis of that taxpayer's experience. Section 448(d)(5) itself has always been clear enough on this point, but Congress's 2002 addition to the statute (which did *not* substantively revise the operative language of § 448(d)(5)) should have removed any conceivable doubts: Congress expressly instructed Treasury to approve *any* request by a taxpayer to use *any* "formula or computation" of excludable receivables, so long as "the computation or formula clearly reflects the taxpayer's experience." 28 U.S.C. § 448(d)(5)(C). The taxpayer may have the burden to show that the method accurately reflects income based on its experience, but so long as it does, § 448(d)(5)'s structure has always contemplated that Treasury will do nothing more

than allow the exclusion.

The new regulation does not operate that way. The new regulation explicitly recognizes there may be a variety of methods other than those set forth in the safe harbors that taxpayers might employ that would better reflect the taxpayers' actual income collection experience. *See* 68 Fed. Reg. at 52498. The new regulation authorizes the use of such methods, but only on the condition that the taxpayer "self-test" the method. And here is the rub: the new regulation authorizes the use of alternative calculation methods only when the self-test shows that they do not estimate more bad debt than any of the safe harbors. *Id.* In other words, *even if* the method the taxpayer seeks to employ indisputably produces a more accurate reflection of actual income, Treasury bars its use, unless it produces as much or more revenue than one of the pre-determined safe harbors. The new regulation, then, does nothing to fulfill the statute's mandate that taxpayers be allowed to use any method that accurately captures their actual receivable income collection experience.

For present purposes, however, the point is not to litigate the validity *vel non* of the safe harbors contained in the new regulation. They are not before the Court in this case and would not be directly relevant if review were granted. The point is to illustrate the true doctrinal issue in this case, and to show why the new regulation does not resolve or even address that issue. The fundamental doctrinal point is that § 448(d)(5) required Treasury to allow taxpayers to calculate exclusions from income on the basis of their actual collection experience, and the Revised Formula impermissibly failed to adhere to that mandate, as does the new regulation. The basic question presented, in other words, is whether § 448(d)(5) requires Treasury to allow taxpayers to use any method that reflects their actual experience. Neither the 2002 statutory addition nor the 2003 regulatory response alters that question. This case, in short, remains an appropriate and effective vehicle for determining the proper scope of Treasury's

authority under § 448(d)(5).

Certainly nobody can contest the importance of the doctrine and policies underlying that issue. This is one of the few instances in the Code where Congress clearly conferred on taxpayers, rather than Treasury, the discretion to determine the means of compliance. Treasury's refusal to accept that mandate – indeed its decision to flout it by requiring hospital taxpayers to do *exactly* what Congress barred Treasury from requiring them to do – has come at a very severe price not just for petitioner in this case, but for a health care system in this country that is, literally and figuratively, already overtaxed. Certiorari should be granted.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

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